INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and other authorities involved	2
Statement	2
Argument	6
Conclusion	10
Appendix	11

CITATIONS

Cases:	
Board of Trade v. *Christie Grain and Stock Co.*, 198 U. S. 236	8
Covington v. *Commissioner*, 42 B. T. A. 601, affirmed, 120 F. (2d) 768, pending on petition for certiorari, Nos. 693–694, present Term	7
United States v. *Coffee Exchange*, 263 U. S. 611	8
Statutes:	
Revenue Act of 1934, 48 Stat. 680:	
Sec. 22 (U. S. C., Title 26, Sec. 22)	11
Sec. 23 (U. S. C., Title 26, Sec. 23)	11
Sec. 117 (U. S. C., Title 26, Sec. 101)	6, 12
Miscellaneous:	
A. R. M. 100, 3 Cum. Bull. 66, 68 (1920)	7
Baer and Woodruff, Commodity Exchanges (1929), pp. 87–88	8
Circular No. 151, United States Department of Agriculture, Hedging in Grain Futures, pp. 30–32 (June, 1931)	9
G. C. M. 17322, XV–2 Cum. Bull. 151 (1936)	7, 14
Hoffman, Future Trading upon Organized Commodity Markets (1932), pp. 4, 382	8
Senate Hearing before the Committee on Agriculture and Forestry on S. 1414, 70th Cong., 1st Sess., p. 9	9
Treasury Regulations 86:	
Art. 22 (c)–1	7, 12
Art. 23 (f)–1	13
Art. 117–1	13
Art. 117–2	13

423663—41——1

In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 671

FARMERS & GINNERS COTTON OIL COMPANY,
PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 35–39) is reported in 41 B. T. A. 1083. Four members dissented and there were two separate dissenting opinions (R. 39–47). The opinion of the Circuit Court of Appeals (R. 114–118) is reported in 120 F. (2d) 772.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 9, 1941 (R. 118). A petition for rehearing filed on June 28, 1941 (R. 119), was

denied on July 11, 1941 (R. 123). The petition for writ of certiorari was filed on October 1, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether losses sustained by the taxpayer, a manufacturer of crude cottonseed oil, from the sales of certain contracts for the future delivery of refined cottonseed oil were deductible only to the extent provided in Section 117 (d) of the Revenue Act of 1934 because they were losses from the sale of "capital assets," as defined in Section 117 (b).

STATUTES AND OTHER AUTHORITIES INVOLVED

The pertinent statutes and other authorities involved are set forth in the Appendix, *infra*, pp. 11–16.

STATEMENT

The facts as found by the Board of Tax Appeals (R. 35–38) from the evidence (R. 62–109) are as follows:

The taxpayer corporation is engaged in the business of operating a cottonseed-oil mill. It buys cottonseed, crushes the seed, and sells the products derived therefrom, consisting of crude cottonseed oil, meal, linters, hulls, fibers, and bran. The crude cottonseed oil is perishable and deteriorates rapidly, especially in warm weather. The crude oil storage facilities of the taxpayer held not more than one-sixth of the annual production of the mill.

Larger storage facilities were impractical not only because of the expense but also because the oil would deteriorate if held. The taxpayer, because of these circumstances, could not retain its crude oil until it could obtain what it regarded as a favorable price, but had to sell during the operating season at the market price whenever its storage tanks were full (R. 35–36).

The practice of the taxpayer has been to buy futures in refined oil when, but only when, it was forced to sell crude at prices which it regarded as unsatisfactory. Refined cottonseed oil may be kept for long periods and has a market throughout the year on produce exchanges. There is a direct relationship between the market price of refined oil and the market price of crude oil as of any given date. The taxpayer purchased quantities of refined oil for future delivery only to offset the sale of like quantities of crude at prices which it regarded as unsatisfactory. It would first sell the crude at prevailing market price and then place orders with brokers for the purchase of refined futures at prices named by the taxpayer. Sometimes several weeks would intervene before the purchase could be made at the prices named. The practice of buying futures was generally followed by others engaged in the same business as the taxpayer (R. 36).

The taxpayer sold 2,280,000 pounds of crude during the taxable year at prices satisfactory to it and

made no offsetting purchases of futures in regard to those sales. It sold the following quantities of crude on the dates mentioned at prices unsatisfactory to it (R. 36):

Date	Pounds	Date	Pounds	Date	Pounds
10/16/35	180,000	10/22/35	180,000	11/20/35	300,000
10/16/35	420,000	10/25/35	60,000	12/6/35	180,000
10/18/35	60,000	10/28/35	180,000	12/6/35	120,000
10/22/35	300,000	10/30/35	360,000	1/8/36	600,000

It purchased futures of refined oil to offset those sales, and its dealings in those futures are shown in the following table (R. 37):

Date acquired	Date sold	Quantity	Losses
		Pounds	
11-22-35	4-13-36	180,000	$2,462.13
11-22-35	4-13-36	120,000	1,653.42
11-26-35	4-13-36	180,000	2,336.13
11-26-35	4-13-36	120,000	1,545.42
1-9-36	4-13-36	300,000	1,328.55
1-9-36	4-13-36	180,000	887.13
1-9-36	4-13-36	120,000	615.42
1-9-36	4-13-36	120,000	639.42
1-9-36	4-13-36	180,000	959.13
2-7-36	4-13-36	60,000	331.71
2-7-36	4-13-36	300,000	1,658.55
12-12-35	4-13-36	120,000	1,521.42
12-12-35	4-13-36	60,000	736.71
12-17-35	4-18-36	120,000	1,389.42
12-17-35	4-21-36	60,000	766.68
12-19-35	4-21-36	60,000	766.68
12-20-35	4-21-36	120,000	1,545.36
12-28-35	4-21-36	60,000	772.68
1-9-36	6-25-36	300,000	2,108.34
Total		2,760,000	24,024.30

The taxpayer bought the futures on margin. The quantity unit in transactions in crude and refined oil is a tank of 60,000 pounds. The rules of the exchange on which the futures were purchased

provide that purchases (R. 37) "of commodities for future delivery are made with the distinct understanding that actual receipt and/or delivery is intended," but the taxpayer never took delivery of any of the refined. Instead, it sold its contracts for future delivery.

The practice of buying futures was a more efficient and less expensive way for the taxpayer to await more favorable markets than the alternative of having its crude oil manufactured into refined and held in storage as its own property. Purchase of cottonseed was not a practical method of protecting the taxpayer against sales at unfavorable prices (R. 37–38).

The taxpayer entered into the transactions in futures solely as a protection against sales of crude oil which it was compelled to make at prices which it deemed unsatisfactory, and those transactions enabled it to maintain a position in respect to future market conditions of refined oil which it was powerless to maintain in respect to crude oil (R. 38).

The futures were bought and sold by the taxpayer only on the New York Produce Exchange, through brokers. The taxpayer had no customers of its own in respect thereto. The contracts were neither stock in trade nor property held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business (R. 38).

The taxpayer on its income tax return for the taxable year claimed deductions for the losses sustained in its transactions in futures. The Commissioner held that the losses resulted from the sale of capital assets within the meaning of Section 117 (b) of the Revenue Act of 1934; limited the deduction to $2,000, as provided in Section 117 (d); and determined a deficiency accordingly (R. 10–13). The Board of Tax Appeals reversed his determination (R. 48), holding that the transaction should be excluded from Section 117 because it was a hedging transaction (R. 48). The Circuit Court of Appeals reversed, with one dissent (R. 118).

ARGUMENT

This case does not present a conflict of decisions. It was correctly decided below and does not call for further review.

1. Deductions on account of losses from sales of capital assets are limited by Section 117 (d) of the Revenue Act of 1934 to $2,000 over gains from such sales. The principal question herein is whether the contracts for future delivery were "capital assets." Section 117 (b) defines capital assets as follows:

> * * * "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the

> taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

The contracts were certainly property held by the taxpayer (*Covington* v. *Commissioner,* 42 B. T. A. 601, affirmed on this point, 120 F. (2d) 768 (C. C. A. 5), pending on petition for certiorari, Nos. 693–694, present Term), and were not one of the three types of property expressly excluded in the statutory definition of "capital assets." They were neither stock in trade, nor were they held by the taxpayer primarily for sale to customers; for, the taxpayer had no customers with respect to these refined cottonseed oil futures, nor did it ever take delivery of the oil involved. Moreover, the contracts were plainly not the type of property which would be included in inventory. See Article 22 (c)–1 of Regulations 86 (Appendix, *infra*); A. R. M. 100, 3 Cum. Bull. 66, 68.

2. Section 117 (b) makes no exception for hedging transactions, nor has any exception been made therefor by Treasury Regulations. However, it has been the practice to permit deductions in full upon losses from true hedging transactions. G. C. M. 17322, XV–2 Cum. Bull. 151. The theory is that hedging is a form of insurance of normal business profits against the risk of fluctuations in

423663—41——2

the market price of the product in which the taxpayer deals or in the market price of the materials which are used by him to make that product.[1] But this case does not present a true hedging transaction.

It is a condition precedent to every hedging operation that there must be an existing trade risk in the cash or spot market at the time that the hedging operation is entered into. Hoffman, Future Trading upon Organized Commodity Markets (1932) 382. Here there was no such existing trade risk at the time of the alleged hedging operations. Such risks as the taxpayer had, due to the fluctuations of prices in the cash market prices of crude cottonseed oil and cottonseed, it took, and, while they existed, the taxpayer did not insure or protect itself against them by hedging. It was not until after these risks had come to an end by sales of crude cottonseed oil in the cash or spot market, sometimes several weeks after, that the taxpayer went into the futures market for refined cottonseed oil. (R. 36.) In doing so, the taxpayer was not

[1] That hedging is a form of insurance of normal business profits against such risks is well recognized. *United States* v. *Coffee Exchange*, 263 U. S. 611, 619; *Board of Trade* v. *Christie Grain and Stock Co.*, 198 U. S. 236, 249; Baer and Woodruff, Commodity Exchanges (1929) 87–88; Hoffman, Future Trading Upon Organized Commodity Markets (1932) 4.

insuring itself against any then existing trade risk in the cash or spot market for crude cottonseed oil or cottonseed. The taxpayer was, therefore, not hedging,[2] and the reason for permitting the deduction in full of losses from a hedging transaction does not exist in this case.

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[2] That what the taxpayer did was not to hedge and what would be a proper hedge for a crude cottonseed oil manufacturer in the refined cottonseed oil futures market is shown by the testimony, before the Committee on Agriculture and Forestry of the United States Senate, of William A. Storts, representing the New York Produce Exchange, which maintains the largest futures market in refined cottonseed oil in the United States and which the taxpayer used for the future transactions involved in the case at bar. He said (Senate Hearing before the Committee on Agriculture and Forestry on S. 1414, 70th Cong., 1st Sess., p. 9 (April 11, 1928)):

"Many of the crude mills do not use the market as a hedge. Some of them do. The proper operation of a crude mill, in my opinion, when the market is used for insurance purposes, is to sell the market when he buys his seed. That is his hedge. There is not more than 1 out of 25 that does that, if there are that many. From what I can understand, the crude mill will buy the seed, produce the crude, and then, when they sell the crude, they buy futures, so that they are always long on the market, in place of having a hedge. That is the way it appears to operate, from the information I get through talking to people about it, in the majority of cases."

See also, United States Department of Agriculture Circular No. 151, Hedging in Grain Futures (June 1931), pp. 30–32.

CONCLUSION

The decision of the court below is correct. There is no conflict with the decision of any other Circuit Court of Appeals or with any decision of this Court. No question of general importance is presented. The petition should be denied.

Respectfully submitted.

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OCTOBER 1941.